

Audit



Report

OFFICE OF THE INSPECTOR GENERAL

INTERNAL CONTROLS AND COMPLIANCE
WITH LAWS AND REGULATIONS FOR THE
DOD MILITARY RETIREMENT TRUST FUND
FINANCIAL STATEMENTS FOR FY 1995

Report No. 96-169

June 19, 1996

19991130 052

Department of Defense

AOI 00-02-0552

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Acronyms

| | |
|-------|--|
| DFAS | Defense Finance and Accounting Service |
| DRAS | Defense Retiree and Annuitant Pay System |
| FMR | Financial Management Regulation |
| IG | Inspector General |
| JFMIP | Joint Financial Management Improvement Program |
| OMB | Office of Management and Budget |
| TERA | Temporary Early Retirement Authority |



**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884**



June 19, 1996

**MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER) AND
CHIEF FINANCIAL OFFICER
UNDER SECRETARY OF DEFENSE (PERSONNEL AND
READINESS)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE**

**SUBJECT: Audit Report on the Internal Controls and Compliance With Laws and Regulations
for the DoD Military Retirement Trust Fund Financial Statements for FY 1995
(Report No. 96-169)**

We are providing this report for information and use. Financial statement audits are required by the Chief Financial Officers Act of 1990 as amended by the Federal Financial Management Act of 1994. Office of Management and Budget Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993, requires the Inspector General, Department of Defense, to render an opinion on the Military Retirement Trust Fund financial statements and report on the adequacy of internal controls and compliance with laws and regulations. The report includes separate sections on "Internal Controls" and "Compliance With Laws and Regulations" in Part I. Part II of the report provides relevant appendixes for management's use.

We issued an unqualified ("clean") audit opinion on the FY 1995 Military Retirement Trust Fund Financial Statements on April 2, 1996. The internal control structure effectively accounted for and managed resources, ensured compliance with laws and regulations, and provided reasonable assurance that the financial statements were free of material misstatements. However, we found certain internal control weaknesses and noncompliances that were not material to the financial statements, but merit management attention. Details are discussed in the reportable conditions in Part I.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Raymond D. Kidd, Audit Program Director, at (703) 604-9110 (DSN 664-9110), or Mr. John M. Seeba, Audit Project Manager, at (703) 604-9134 (DSN 664-9134). The distribution of this report is in Appendix F. The audit team members are listed inside the back cover.

**Robert J. Lieberman
Assistant Inspector General
for Auditing**

Office of the Inspector General, DoD

Report No. 96-169
(Project No. 5FH-2025.01)

June 19, 1996

**Internal Controls and Compliance With Laws and Regulations
for the DoD Military Retirement Trust Fund Financial
Statements for FY 1995**

Executive Summary

Introduction. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires an annual audit of the financial statements of the DoD Military Retirement Trust Fund (the Fund). The DoD Military Retirement Trust Fund Financial Statements for FY 1995 reported total assets of \$131 billion, investments of \$126.7 billion, and a future funding requirement of \$407.2 billion. The Fund Manager is the Deputy Under Secretary of Defense (Requirements and Resources). Since we issued the DoD Inspector General Report No. 93-136, DoD Military Retirement Trust Fund Financial Statements for FY 1992, June 30, 1993, the DoD Military Trust Fund has undergone significant restructuring. The Defense Finance and Accounting Service (DFAS) standardized and consolidated the military retired and annuity pay systems and operations into one system that is operated at the DFAS Cleveland and Denver Centers. Prior to the consolidation, the DoD Military Retirement Trust Fund paid retirees, former spouses, and annuitants from eight military retiree and annuitant pay systems operating at four DFAS Centers. The consolidation began in May 1993 and was completed in April 1995. The Fund manager, the Under Secretary of Defense (Comptroller), DFAS management and the Office of the DoD Actuary are responsible for establishing internal controls and compliance with laws and regulations.

Audit Objectives. The objective of the audit was to determine whether the DoD Military Retirement Trust Fund Financial Statements for FY 1995 were fairly presented in accordance with Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. In addition, we assessed the internal controls and compliance with laws and regulations related to the financial statements. We followed up on conditions noted in our previous audit of the Fund's financial statements. See Appendix A for a discussion of the audit scope and methodology.

Unqualified Audit Opinion. We issued an unqualified ("clean") audit opinion on the FY 1995 DoD Military Retirement Trust Fund Financial Statements on April 2, 1996. Our audit opinion was included in the published financial statements transmitted by the Under Secretary of Defense (Comptroller) to the Office of Management and Budget. See Appendix B for the financial statements and the audit opinion.

Change in Accounting Method. In FY 1995, the Fund changed its method of reporting the unfunded liability. This liability will now be reported as of the beginning of the fiscal year. This change is in accordance with Statement of Financial Accounting Standards No. 35, "Accounting and Reporting by Defined Benefit Pension Plans," March 1980, and is described in more detail in the footnotes of the financial statements.

Internal Controls. Overall, management has established a sound internal control structure over Fund activities. The internal control structure was effective in accounting for and managing resources, ensuring compliance with laws and regulations, and providing reasonable assurance that the financial statements are free of material misstatements. Management has also established internal controls for reporting performance measures. However, we found internal control weaknesses over debt collection techniques at the DFAS Cleveland and Denver Centers, and retiree disbursements from the proper appropriation at the DFAS Cleveland Center. We also identified errors in the payment computations for 4 of 250 retiree and annuitant accounts we reviewed during the audit. Those weaknesses were not material to the financial statements, but the weaknesses over debt collection techniques are considered noncompliant with Public Law 97-365, the "Debt Collection Act of 1982," October 25, 1982. Part I.A. contains our report on internal controls.

Additionally, DFAS Cleveland Center 1995 Annual Statement of Assurance reported two material internal management control weaknesses as defined by DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987, that were directly related to the Military Retirement Trust Fund. The DFAS also reported those weaknesses in the combined DFAS 1995 Annual Statement of Assurance. The DFAS Cleveland Center reported that there was no reconciliation between the retired pay system and Military Service personnel systems and that there were delays in appointing trustees for mentally incompetent Air Force retirees. We did not identify any significant errors in the Defense Retiree and Annuitant Pay System data or computations during our review of internal controls at the DFAS Cleveland Center and our recomputation of retiree and annuitant payments that would indicate that those material internal control weaknesses had a material effect on the FY 1995 DoD Military Retirement Trust Fund Financial Statements.

Compliance with Laws and Regulations. We reviewed compliance with selected provisions of laws and regulations as they pertain to the accuracy of the financial statements. Our tests of compliance did not disclose any material noncompliance affecting the financial statements. Management did not comply, however, with the requirements of the Federal Financial Management Act of 1994, which required the submission of audited financial statements to the Office of Management and Budget by March 1, 1996. We were unable to provide an audit opinion on the financial statements to the Under Secretary of Defense (Comptroller) before March 1, 1996, because of delayed submission. The IG, DoD, will be unable to issue audit opinions when due if the financial statements are not provided to us in sufficient time to complete our audit work before the March 1 deadline. Additionally, the DFAS Cleveland and Denver Centers did not fully comply with the Debt Collection Act of 1982, Public Law 97-365, because they did not consistently assess interest on debts owed to the Fund by retirees and annuitants. Except for the minor noncompliances described above, management complied with the provisions we reviewed. With respect to items not tested, nothing came to our attention that caused us to believe the DoD Military Retirement Trust Fund had not complied, in all material respects, with those provisions identified above. Part I.B. contains our report on compliance with laws and regulations.

Table of Contents

| | |
|--|----|
| Executive Summary | i |
| Part I - Audit Results | |
| Audit Background | 2 |
| Audit Objectives | 3 |
| Part I. A. Review of Internal Control Structure | |
| Introduction | 6 |
| Reportable Conditions | 7 |
| Summary | 9 |
| Part I. B. Review of Compliance with Laws and Regulations | |
| Introduction | 12 |
| Reportable Conditions | 12 |
| Part II - Additional Information | |
| Appendix A. Scope and Methodology | 14 |
| Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995 | 19 |
| Appendix C. Prior Audits and Other Reviews | 51 |
| Appendix D. Laws and Regulations Reviewed | 52 |
| Appendix E. Organizations Visited or Contacted | 54 |
| Appendix F. Report Distribution | 56 |

Part I - Audit Results

Audit Background

Fund Management. The Chief Financial Officers Act, as amended by the Federal Financial Management Act of 1994, requires audited financial statements for trust funds such as the DoD Military Retirement Trust Fund (the Fund). The designated Fund Manager is the Deputy Under Secretary of Defense (Requirements and Resources). The Under Secretary of Defense (Comptroller), and the Defense Finance and Accounting Service are responsible for accounting policy and accounting systems, and for preparing the financial statements in coordination with the Office of the DoD Actuary. Collectively, these individuals and organizations make up the Fund management.

Audit Opinion. We issued an unqualified audit opinion for the FY 1995 DoD Military Retirement Trust Fund financial statements on April 2, 1996. Our opinion was included in the financial statements transmitted by the Under Secretary of Defense (Comptroller) to the Office of Management and Budget. See Appendix B for the audit opinion and financial statements.

System Changes. The DFAS standardized and consolidated the military retired and annuity pay systems and operations into the Defense Retiree and Annuitant Pay System that is operated at the DFAS Cleveland and Denver Centers. The Defense Retiree and Annuitant Pay System consists of two subsystems that gather, store, and process the data required to generate and account for the payments made by the DoD Military Retirement Trust Fund to retirees, former spouses, and annuitants. Prior to the consolidation, the DoD Military Retirement Trust Fund paid retirees, former spouses, and annuitants from eight military retiree and annuitant pay systems operating at four DFAS Centers. The consolidation began in May 1993 and was completed in April 1995. As a result of the consolidation, the Cleveland Center establishes and maintains retiree accounts and the Denver Center establishes and maintains annuitant accounts.

Change in Accounting Method. In FY 1995, the Fund changed its method of reporting the unfunded liability. This liability will now be reported as of the beginning of the fiscal year. This change is in accordance with Statement of Financial Accounting Standards No. 35 and is described in more detail in the footnotes of the financial statements. See Appendix B for the financial statements.

Audit Objectives

Our overall objective was to determine whether the DoD Military Retirement Trust Fund Financial Statements for FY 1995 were presented fairly in accordance with Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. Additional objectives were to evaluate internal controls and compliance with applicable laws and regulations related to the financial statements. We followed up on conditions noted in our previous audit of the Fund's financial statements. Part I.A. contains our report on internal controls. Part I.B. contains our report on compliance with laws and regulations. Part II, Appendix A. provides the scope and methodology and also contains the auditing standards and accounting principles.

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Part I. A. - Review of Internal Control Structure

Introduction

Audit Responsibilities. Our audit objective was to determine whether controls over transactions supporting the accounts in the FY 1995 financial statements were adequate to provide reasonable assurance that the accounts were free of material error. In planning and performing our audit of the Fund for the year ended September 30, 1995, we evaluated the internal control structure, including implementation of the DoD management control program. The purposes of this evaluation were to:

- o determine our auditing procedures for expressing an opinion on the financial statements; and
- o determine whether an internal control structure had been established.

That determination included obtaining an understanding of the internal control policies and procedures, as well as assessing the level of control risk relevant to all significant cycles, classes of transactions, and account balances. For those significant control policies and procedures that had been properly designed and placed in operation, we performed sufficient tests to provide reasonable assurance that the controls were effective and working as designed. For areas where internal controls were determined to be weak, we attempted to perform tests to determine the level of assurance that could be placed on those controls.

Management Responsibilities. Management of the Fund is responsible for establishing and maintaining an internal control structure. That responsibility requires management to make estimates and judgments to assess the expected benefits and related costs of internal control policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that:

- o transactions are properly recorded and accounted for in order to prepare reliable financial statements and to maintain accountability over assets;
- o funds, property, and other assets are safeguarded against waste, loss, unauthorized use, and misappropriation; and
- o transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements, and in compliance with any other laws and regulations that the OMB, entity management, or the IG, DoD, have identified as being significant for which compliance can be objectively measured and evaluated.

Internal Control Structure. The three elements of the control structure are the control environment, accounting and related systems, and control procedures. The control environment is the collective effort of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. The control environment reflects the overall attitude, awareness, and actions of management concerning the importance of control and the emphasis placed on it within the entity. Accounting and related systems are the methods and records established to identify, assemble, analyze, classify, record, and report on the entity's transactions and to maintain accountability for the related assets and liabilities. Control procedures are the policies and procedures in addition to the control environment and accounting and related systems that management has established to provide reasonable assurance that specific entity objectives will be achieved.

Reportable Conditions

Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to effectively control and manage its resources and ensure reliable and accurate financial information for use in managing and evaluating operational performance. A material weakness is a reportable condition in which the design or operation of the specific internal control structure element does not reduce to a relatively low level the risk that errors or irregularities could occur. Such errors or irregularities would be in amounts that would be material to the statements being audited and not be detected within a timely period by employees in the normal course of performing their functions.

Material Weaknesses Reported by Management. The DFAS reported two material internal control weaknesses in the combined Defense Finance and Accounting Service FY 1995 Annual Statement of Assurance that related directly to the Fund. The weaknesses were related to reconciling the retired pay system to Military Service personnel systems and delays in processing certain Air Force retiree accounts. The DFAS Cleveland Center reported that there is no reconciliation between the Defense Retiree and Annuitant Pay System and the Services' personnel systems which would assist in resolving errors in data elements and in identifying fraudulent or erroneous accounts. Additionally, the Cleveland Center reported as a material weakness response processing delays in appointing trustees for mentally incompetent Air Force retirees. That, in turn, may delay payments to the retirees or result in improper payments to the trustees. We agree that these are material weaknesses for reporting under DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987, and reportable under OMB Bulletin No. 93-06, "Audit Requirements for

Federal Financial Statements," January 8, 1993. However, those weaknesses did not have a material effect on the DoD Military Retirement Trust Fund Financial Statements for FY 1995. We did not identify any significant errors in the Defense Retiree and Annuitant Pay System (DRAS) data or computations during our review of the internal controls at the Cleveland Center and our recomputation of the payments made by the Fund to 150 retirees and 100 annuitants. Significant errors would indicate that the material internal control weaknesses reported by the Cleveland Center and the DFAS on the 1995 Annual Statements of Assurance had a material effect on the DoD Military Retirement Trust Fund Financial Statements for FY 1995.

We classified the significant internal controls, policies, and procedures into the following categories: Investments, Payments, Contributions, and Actuarial Cycles. Our evaluation of the internal control structure included all of these categories. We did not identify any material internal control weaknesses during our review of those account balances that would affect the financial statements.

We noted other matters involving the internal control structure and its operations that were not material to the Fund; however, they require disclosure. We found internal control weaknesses over debt collection techniques at the DFAS Cleveland and Denver Centers and over retiree payments being disbursed from the proper appropriation at the Cleveland Center. Additionally, we identified errors in the payment computations for 1 of the 150 retiree and 3 of the 100 annuitant accounts that we reviewed during our recomputation tests.

Debt Collection Techniques. The DFAS Cleveland and Denver Centers did not consistently apply Public Law 97-365, the "Debt Collection Act of 1982," October 25, 1982, to retiree and annuitant debts owed to the Fund. Public Law 97-365 authorizes Federal agencies to assess interest, penalties, and administrative charges on debts owed by individuals. The DFAS Cleveland Center implemented new policy and the DFAS Denver Center developed a systems change request during 1995 requiring the assessment of interest on retiree and annuitant debt. However, the DFAS Cleveland Center had not implemented the controls to ensure that the interest was consistently assessed on debts owed to the Fund by retirees. Additionally, the DFAS Denver Center had not implemented the systems change request during FY 1995. As a result, retirees and annuitants were receiving interest-free loans, and the United States Government was not receiving the required interest revenue.

Disbursements from Appropriations. We also determined that there were internal control weaknesses over disbursements from the proper appropriation for certain retiree payments at the DFAS Cleveland Center. Public Law 102-484, the "National Defense Authorization Act for Fiscal Year 1993," October 23, 1992, grants the Military Services temporary early retirement authority (TERA) to offer early retirements to members with more than 15 but less than 20 years of service. The TERA retirees should be paid

from each Service's military personnel funding appropriation until the retiree has reached 20 years of service at which time the pay is recomputed and the payment is made from the Fund. However, the DFAS Cleveland Center did not establish internal controls to ensure that individuals retiring under the TERA were paid from the Services' appropriation and that payments to TERA retirees were made from the Fund after those retirees met their 20-year service requirement. As a result during FY 1995, the Fund was overcharged \$2.3 million for disbursements to TERA retirees that should have been paid from the Military Service's personnel appropriations. The disbursements from the incorrect appropriations occurred because of a lack of coordination between the Disbursing Office and the Office of Retired Pay at the Cleveland Center in establishing the proper appropriations and in identifying subsequent changes to the classification of retirees between the Fund's and the Services' appropriations. The Cleveland Center has corrected the disbursements made for Army, Navy, and Air Force retirees and anticipates correcting disbursements for Marine Corps retirees in FY 1996. Additionally, the Cleveland Center is producing specialized reports for the monthly retiree payroll disbursements in order to verify that the TERA disbursements will be made from the proper appropriations in the future.

Payment Computations. During our recomputation tests, we identified manual errors in 1 of the 150 retiree and 3 of the 100 annuitant payment computations made by the DFAS Centers. The DFAS Cleveland Center overpaid the retiree \$1,768 in FY 1995 (total overpayment \$21,726) because the incorrect rank was established in the retiree's DRAS account. Additionally, the DFAS Denver Center made inaccurate payments to three annuitants based on data transferred from the DFAS Indianapolis Center. The DFAS Denver Center did not charge the first annuitant for the full cost of the annuity plan which caused the annuitant to be overpaid \$377 in FY 1995 (total overpayment \$7,879). The second annuitant was underpaid \$312 in FY 1995 (total underpayment \$390) because he was being overcharged for the cost of the plan. The third annuitant's initial cost of living adjustment was not correctly applied, which caused the annuitant to be underpaid \$463 in FY 1995 (total underpayment \$4,407). We determined that those errors did not have a material effect on the financial statements and did not indicate a systemic weakness in internal controls.

Summary

Overall internal controls for the Fund appear to be working as designed. Although we found instances of control breakdown, we believe the internal control structure is adequate and effective to identify any potential problems that could have a material effect on the financial statements.

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Part I. B. - Review of Compliance With Laws and Regulations

Introduction

We evaluated the DoD Military Retirement Trust Fund for material instances of noncompliance with laws and regulations for the fiscal year ended September 30, 1995. Our objective was to assess compliance with laws and regulations to obtain reasonable assurance that the financial statements were free of material misstatements and not to provide an opinion on overall compliance with such provisions. Fund management is responsible for ensuring compliance with laws and regulations applicable to the Fund. The list of laws and regulations we reviewed is in Part II, Appendix D.

Reportable Conditions

Material instances of noncompliance are failures to follow requirements, laws or regulations that cause us to conclude that the aggregation of the misstatements resulting from those failures is either material to the financial statements, or the sensitivity of the matter would cause others to perceive it as significant.

Our tests of compliance with laws and regulations did not disclose any material weaknesses affecting the financial statements. Management did not comply, however, with the requirements of the Federal Financial Management Act of 1994, which required the submission of audited financial statements to the Office of Management and Budget by March 1, 1996. We were unable to provide an audit opinion on the financial statements to the Under Secretary of Defense (Comptroller) by March 1, 1996, because of delayed submission. The IG, DoD, will continue to be unable to issue audit opinions when due if the financial statements are not provided to us in sufficient time to complete our audit work before the March 1 deadline.

The results of our tests indicate that with respect to the items tested, except for noncompliance with the timing prescribed in the Federal Financial Management Act of 1994 and with Public Law 97-365, the "Debt Collection Act of 1982," October 25, 1982, the Fund complied in all material respects with the provisions referred to in the Audit Objectives. The noncompliance with the Debt Collection Act of 1982 was discussed as a reportable condition in our review of internal controls (see Part I.A.).

Except for these minor noncompliances described above, management complied with the provisions we reviewed. With respect to items not tested, nothing came to our attention that caused us to believe that Fund management had not complied, in all material respects, with those provisions identified above.

Part II - Additional Information

Appendix A. Scope and Methodology

Statements Reviewed. We examined the Principal Statements and the Notes to the Principal Statements of the DoD Military Retirement Trust Fund for the fiscal year ended September 30, 1995. The Principal Statements include the Statement of Financial Position and the Statement of Operations and Changes in Net Position. Also included are the Footnotes, Overview, and Supplemental Information. The Principal Statements upon which our opinion is based were dated April 1, 1996.

Auditing Standards. We conducted our audit in accordance with generally accepted Government auditing standards issued by the Comptroller General of the United States (the Comptroller General), as implemented by the IG, DoD, and OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Principal Statements are free of material misstatements. We relied on the guidelines suggested by the GAO and our professional judgment in assessing the materiality of matters affecting the fair presentation of the financial statements and related internal control weaknesses.

Accounting Principles. Accounting principles and standards for the Federal Government remain under development. The Federal Accounting Standards Advisory Board was established to recommend Federal accounting standards to the Director, OMB; the Secretary of the Treasury; and the Comptroller General, who are the principals of the Joint Financial Management Improvement Program (JFMIP). Specific standards agreed on by those three officials are issued by the Director, OMB, and the Comptroller General. To date, five accounting standards and two accounting concepts have been published in final form, and three accounting standards have been released in draft form. See Table 1 for a list of the accounting standards and concepts.

Until all aspects of financial statement reporting are governed by accounting standards that will constitute "generally accepted accounting principles for the Federal Government," agencies are required to follow the hierarchy of accounting principles described in OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. The hierarchy constitutes an "other comprehensive basis of accounting" to be used for preparing Federal agencies' financial statements. A summary of the hierarchy defined and approved by the JFMIP Principals is as follows:

- standards agreed to and published by the JFMIP Principals,
- form and content requirements of the OMB,

- accounting standards contained in agency guidance on accounting policies, and
- accounting principles published by other authoritative sources.

Because only five accounting standards and two accounting concepts have been published by the JFMIP Principals, most accounting standards for the DoD "other comprehensive basis of accounting" are contained in DoD accounting policy guidance. Previously, DoD Manual 7220.9-M, the "DoD Accounting Manual," was the primary DoD accounting guidance. Since FY 1992, the USD(C) has updated sections of the "DoD Accounting Manual," and has incorporated those sections into new volumes of the Financial Management Regulation (FMR). The USD(C) plans to replace all sections of the "DoD Accounting Manual" with the FMR. The FMR, once completed, will serve as the single DoD-wide financial management regulation for use by all DoD Components for accounting, budgeting, finance, and financial management education and training.

Appendix A. Scope and Methodology

Table 1. OMB Statements of Federal Financial Accounting Standards and Concepts

| <u>Number</u> | <u>Title</u> | <u>Status</u> | <u>Date</u> |
|----------------|--|---------------|-------------------|
| Standard No. 1 | Accounting for Selected Assets and Liabilities | Final | March 30, 1993 |
| Standard No. 2 | Accounting for Direct Loans and Loan Guarantees | Final | August 23, 1993 |
| Standard No. 3 | Accounting for Inventory and Related Property | Final | October 27, 1993 |
| Standard No. 4 | Managerial Cost Accounting Concepts and Standards for the Federal Government | Final | July 31, 1995 |
| Standard No. 5 | Accounting for Liabilities of the Federal Government | Final | September 1995 |
| Concept No. 1 | Objectives of Federal Financial Reporting | Final | September 2, 1993 |
| Concept No. 2 | Entity and Display | Final | June 6, 1995 |
| TBD | Accounting for Property, Plant, and Equipment | Draft | February 28, 1995 |
| TBD | Accounting for Revenue and Other Financing Sources | Draft | July 1995 |
| TBD | Supplementary Stewardship Reporting | Draft | August 1995 |

Scope of the Review of Internal Controls. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements, including the accompanying notes. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statements. We believe that our audit efforts provide a reasonable basis for our results.

Our review of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions, and would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

We reviewed the internal controls over the establishment and management of retiree and annuitant accounts at the DFAS Cleveland and Denver Centers.

Additionally, we statistically selected 150 retiree and 100 annuitant accounts from the DRAS data reported by the DFAS Cleveland and Denver Centers to the Defense Manpower Data Center, Monterey, California, to verify the reliability of the retiree and annuitant data maintained in the DRAS and the accuracy of the DRAS computations. We compared the DRAS data with data in source documents to determine whether the retiree and annuitant data maintained in the DRAS were valid and accurate. Additionally, we recomputed the monthly gross retiree and annuitant pay amount based on original source documents to determine whether the DRAS computations were accurate.

We tested retiree and annuitant debts owed to the Fund to determine whether the DFAS Cleveland and Denver Centers complied with Public Law 97-365, the "Debt Collection Act of 1982," October 25, 1982, and assessed interest on those debts.

We reviewed the internal controls over the management and computation of the investments and contributions and recomputed the amount of the investment and contributions based on supporting documentation.

Scope of the Review of Compliance With Laws and Regulations. Compliance with laws and regulations is the responsibility of the Fund's managers. As part of our examination to obtain reasonable assurance that the Principal Statements were free of material misstatements, we performed tests of compliance with laws and regulations that may directly affect the financial statements and other laws and regulations designated by the OMB and DoD. See Part II, Appendix D, for a list of laws and regulations reviewed.

As part of our examination, we reviewed management's compliance with DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987. We compared management's most recent Annual Statement of Assurance with our evaluation of the Fund's policies, procedures, and systems for documenting and supporting financial, statistical, and other information presented to us in the Overview to the Fund's Principal Statements, as well as supplemental financial and management information. It was not our objective, however, to provide an opinion on overall compliance with such provisions.

Time Period and Locations. The audit was conducted from June 1995 to March 1996 at the Defense Finance and Accounting Service Headquarters, DFAS Cleveland and Denver Centers, the Office of the DoD Actuary, and the Bureau of Naval Personnel. A complete list of organizations visited or contacted is in Part II, Appendix E.

Computer-Processed Data. To achieve the audit objective, we relied on computer-processed data in the DRAS and the Military Service payroll systems. We assessed the reliability of the DRAS data by reviewing the general controls at the DFAS Cleveland and Denver Centers. We determined that the retiree and

Appendix A. Scope and Methodology

annuitant data maintained in the DRAS were valid and accurate by comparing retiree and annuitant data maintained in that system to data in source documents. We also determined that the DRAS accurately computed the monthly gross pay amount for those retirees and annuitants by independently recomputing the pay based on original source documents. Additionally, we relied on the base pay data reported in the Military Service payroll systems to recompute the amount of the FY 1995 contributions the Military Services were required to make to the Fund. We accepted the base pay amounts as reported in the Military Service payroll systems and we did not test those systems. We did not identify any significant errors in the DRAS data or computations during our review of the internal controls at the DFAS Cleveland and Denver Centers. Our recomputations of the retiree and annuitant payments, Fund investments, and contributions would indicate that the computer-processed data were reliable. As a result of the audit work performed, nothing came to our attention that caused us to believe that the computer-processed data used by the DFAS in compiling the Fund's financial statements were not reliable.

Additionally, we reviewed the "1995 Federal Managers' Financial Integrity Act, Section 4, Annual Statement of Assurance" report for the DFAS Cleveland and Denver Centers and the combined statement for the DFAS to determine whether management identified any weaknesses for the DRAS. We also reviewed the "System Manager/User Review Guide for Operational Systems Fiscal Year 1995," that forms the basis for the annual Section 4 Report. The system manager for the DRAS certified that in FY 1995 the DRAS systems software, operations, or interfaces did not include any departures or noncompliances from the mandatory and applicable Key Accounting Requirements included in the System Manager/User Review Guide. The DFAS Cleveland Center reported in the 1995 Section 4 Report that the DRAS was an operating accounting system substantially in compliance with General Accounting Office accounting principles, standards, and requirements based on the system manager's review.

**Appendix B. DoD Military Retirement Trust
Fund Financial Statements for FY 1995**

DoD Military Retirement Trust Fund

Chief Financial
Officer
Annual Financial
Statement
FY 1995

March 1, 1996

DOD MILITARY RETIREMENT TRUST FUND

Table of Contents

| | |
|---|----|
| Overview | 1 |
| Principal Statements | 11 |
| Footnotes to the Principal Statements | 19 |
| Audit Opinion | 27 |

Overview

***DOD
MILITARY RETIREMENT
TRUST FUND***

OVERVIEW

Overview _____

Overview

SUMMARY OF THE MILITARY RETIREMENT SYSTEM

AS OF SEPTEMBER 30, 1995

A. OVERVIEW

The military retirement system applies to members of the Army, Navy, Marine Corps, and Air Force. However, most of the provisions also apply to retirement systems for members of the Coast Guard (administered by the Department of Transportation), officers of the Public Health Service (administered by the Department of Health and Human Services), and officers of the National Oceanic and Atmospheric Administration (administered by the Department of Commerce). Those not in plans administered by the Department of Defense are not included in this valuation.

The system is a funded, noncontributory defined-benefit plan that includes nondisability retired pay, disability retired pay, retired pay for reserve service, and survivor annuity programs. The Service Secretaries approve immediate nondisability retired pay at any age with credit of at least 20 years of active-duty service. Reserve retirees must be 60 years old with 20 creditable years of service before retired pay commences. *The National Defense Authorization Act for FY 93 (P.L. 102-484) grants temporary early retirement authority (TERA) for the military services to offer early retirements to members with more than 15 but less than 20 years of service. As of September 30, 1995, there were 33,710 TERA retirees receiving monthly retired pay of \$31.6 million. This authority is scheduled to expire at the end of FY99.*

There are three distinct nondisability benefit formulas (relevant to three distinct populations) within the military retirement system. Military personnel who first became members of the Armed Services before September 8, 1980 have retired pay equal to (terminal basic pay) times (a multiplier). The multiplier is equal to (2.5% times (years of service) and is limited to 75%. If the retiree first became a member of the Armed Services on or after September 8, 1980, the average of the highest 36 months of basic pay is used instead of terminal basic pay. Members first entering the Armed Services on or after August 1, 1986 are subject to a penalty if they retire with less than 30 years of service; at age 62, their retired pay is recomputed without the penalty.

Overview

Retiree and survivor benefits are automatically adjusted annually to protect the purchasing power of initial retired pay. The benefits associated with members first entering the Armed Services before August 1, 1986 are adjusted by the percentage increase in the average Consumer Price Index (CPI). This is commonly referred to as full CPI protection. Benefits associated with members entering on or after August 1, 1986 are annually increased by the percentage change in the CPI minus 1%. At the member's age 62, the benefits are restored to the amount that would have been payable had full CPI protection been in effect. This restoral is in combination with that described in the previous paragraph. However, after this restoral, partial indexing (CPI minus 1%) continues annually for life.

Nondisability Retirement From Active Service

The current system allows voluntary retirement upon completion of least 20 years of service at any age, subject to Service Secretary approval. The military retiree receives immediate retired pay calculated as (basic pay) times (a multiplier). Base pay is equal to terminal basic pay if the retiree first became a member of the Armed Services before September 8, 1980. It is equal to the average of the highest 36 months of basic pay for all other members. The multiplier is equal to (2.5%) times (years of service, rounded down to the nearest month) and is limited to 75%. Members who first entered the Armed Services on or after August 1, 1986, and who retire with less than 30 years of service receive a temporary penalty until age 62. The penalty reduces the multiplier by one percentage point for each full year of service under 30. For example, the multiplier for a 20-year retiree would be 40% (50% minus 10%). At age 62, the retired pay is recomputed with the penalty removed.

In FY95, 1.27 million nondisability retirees from active duty were paid \$22.897 billion

Disability Retirement

A disabled military member is entitled to disability retired pay if the disability is at least 30% (under a standard schedule of rating disabilities by the Veterans Administration) and either: (1) the member has eight years of service; (2) the disability results from active duty; or (3) the disability occurred in the line of duty during a time of war or national emergency or certain other time periods.

In disability retirement, the member receives retired pay equal to the larger of (1) the accrued nondisability retirement benefit, or (2) base pay multiplied by the rated percent of disability. The benefit cannot be more than 75% of base pay. Only the excess of (1) over (2) is subject to Federal income taxes. Base pay is equal to terminal basic pay if the retiree first became a member of the Armed Services before September 8, 1980. If the retiree first entered the military on or after September 8, 1980, base pay is equal to the average of the highest 36 months of basic pay.

Overview

Members whose disabilities may not be permanent are placed on a temporary-disability retired list and receive disability retirement pay just as if they were permanently disabled. However, they must be physically examined every 18 months for any change in disability. A final determination must be made within five years. The temporary-disability pay is calculated like the permanent-disability retired pay, except that it can be no less than 50% of base pay.

In FY95, 122,000 disability retirees were paid \$1.50 billion.

Reserve Retirement

Members of the reserves may retire after 20 years of creditable service, the last eight of which must be in a reserve component. However, reserve retired pay is not payable until age 60. Retired pay is computed as (base pay) times (2.5%) times (years of service). If the reservist was first a member of the Armed Services before September 8, 1980, base pay is defined as the active duty basic pay in effect for the retiree's grade and years of service at the time the retired pay begins. If the reservist first became a member of the Armed Services on or after September 8, 1980, base pay is the average basic pay for the member's grade in the last three years that he/she was a member of the Armed Services. In effect, the retired pay of any member who entered the Armed Forces on or after September 8, 1980, and who separates from a reserve component before turning 60 is based on active duty pay at the time of separation.

The years of service are determined by using a point system, where 360 points convert to a year of service. Typically, a point is awarded for a day of service or a drill attendance, with 15 points being awarded for a year's membership in a reserve component. A creditable year of service is one in which the member earned at least 50 points. A member cannot retire without 20 creditable years, although points earned in non-creditable years are used in the retirement calculation.

In FY95, 209,000 reserve retirees were paid \$2.02 billion.

Survivor Benefits

Legislation originating in 1953 provided optional survivor benefits. It was later referred to as the Retired Servicemen's Family Protection Plan (RSFPP). The plan proved to be expensive and inadequate since the survivor annuities were never adjusted for inflation and could not be more than 50% of retired pay. RSFPP was designated to be self-supporting in the sense that the present value of the reductions to retired pay equaled the present value of the survivor annuities.

On September 21, 1972, RSFPP was replaced by the Survivor Benefit Plan (SBP) for new retirees. RSFPP still covers those servicemen retired before 1972 who did not convert to the new plan and still pays survivor annuities.

Overview

Retired pay is reduced, before taxes, for the member's cost of SBP. Since the present value of the reductions in retired pay of all participating members is only a portion of the present value of SBP benefits payable under the program, total SBP costs are shared by the Government and retirees.

The SBP survivor annuity is initially 55% of the member's base amount. The base amount is elected by the member, but cannot be less than \$300 or more than the member's full retired pay. If a penalty for service under 30 years is included in the calculation of retired pay, the maximum base amount is equal to the full retired pay without the penalty.

The spouse's annuity is considered a two-tier benefit because, at age 62, the annuity is reduced to 35% of the base amount. Prior to the enactment of the two-tier benefit, survivor annuities were integrated with Social Security. SBP participants and active and reserve personnel with at least 20 years of service on October 1, 1985, were grandfathered into the two-tier system. Their survivors will be given the higher of the two annuities at age 62.

During FY87 the SBP program's treatment of survivor remarriages changed. Prior to the change, a surviving spouse remarrying before age 60 had the survivor annuity suspended. This age was lowered from 60 to 55. (If remarriage ends in divorce or death the annuity is reinstated.)

Members who die on active duty with over 20 years of service are assumed to have retired on the day they died and to have elected full SBP coverage for spouses and any eligible children.

SBP annuities are reduced by any VA survivor benefits and all premiums relating to the reductions are returned to the survivor. Additionally, SBP annuities are annually increased with cost-of-living adjustments (COLAs). These COLAs may be based on full or partial CPI increases, depending on when the member first entered the Armed Services. If the member dies before age 62 and the survivor is subject to partial COLAs, the survivor's annuity is increased (on the member's 62nd birthday) to the amount that would have been payable had full COLAs been in effect. Partial COLAs continue annually thereafter.

For reserve retirees, the same set of retired pay reductions apply to survivor benefits after the reservist reaches age 60 (when the reservist begins to receive retired pay). A second set of optional reductions (funded by the member only) extends this coverage to reservists who have enough service to retire, but have not attained age 60. The added cost of the pre-age 60 coverage is deducted from the member's retired pay and the survivor's annuity.

In FY95, 211,000 surviving families were paid \$1.41 billion.

Overview

Cost-of-Living Increases

All nondisability retirement, disability retirement, and most survivor annuities are adjusted annually for inflation. COLAs are automatically scheduled to occur every 12 months, on December 1st, to be reflected in checks issued at the beginning of January. These increases are scheduled to be delayed by nine months through 1998.

The "full" COLA increase normally effective December 1 is computed by calculating the percentage increase in the CPI from the third quarter of the prior calendar year to the third quarter of the current calendar year. The increase is based on the Urban Wage Earner and Clerical Worker Consumer Price Index (CPIW) and is rounded to the nearest 1/10 of one percent.

The benefits of retirees (and their survivors) first entering the Armed Services before August 1, 1986 are annually increased with the full COLA; all other benefits are annually increased with a "partial" COLA. The partial COLA is the full COLA minus 1%. A onetime restoral is given to a partial-COLA recipient on the first day of the month after the retiree's 62nd birthday. At this time, the retiree benefit (or survivor benefit, if the retiree is deceased) is increased to the amount that would have been payable had full COLAs been in effect. Annual partial COLAs continue after this restoral.

Relationship with Veterans Administration Benefits

The Veterans Administration (VA) provides compensation for Service-connected and certain non-Service-connected disabilities. These VA benefits can be in place of (or in combination with) DoD retired pay, but they are not additive. Since VA benefits are exempt from Federal income taxes, it is sometimes to the advantage of a member to elect them.

VA benefits also overlap survivor benefits through the Dependence and Indemnity Compensation (DIC) program. DIC is payable to survivors of veterans who died from Service-connected causes. Although an SBP survivor annuity must be reduced by the amount of any DIC benefit, all SBP premiums relating to the reduction are returned to the survivor.

Overview

Interrelationship with Other Federal Service

For retirement purposes, no credit is given for other Federal service, except where cross-service transferability is allowed. Military service is generally creditable toward the Federal civilian retirement systems if military retired pay is waived. However, a deposit (equal to a percentage of post-1956 basic pay) must be made to the Civil Service Retirement Fund in order to receive credit. Military service is not generally creditable under both systems (but is for reservists and certain disability retirees). Retired regular officers employed by the Federal Government lose a substantial portion of their retired pay while so employed, and all retired members are subject to a combined ceiling equivalent to level V of the Executive Schedule. The ceiling does not apply to those who had retired before October 13, 1978 (or were under age 60 and eligible for reserve retirement on that date) and were continuously employed by the Federal Government since that date.

Relationship of Retired to Military Compensation

Basic pay is the only element of military compensation upon which retired pay is computed and entitlement is determined. Basic pay is the principal element of military compensation that all members receive; but it is not truly comparable to salary levels in the public or private sectors. Reasonable comparisons can be made, however, to basic military compensation (BMC) or regular military compensation (RMC). BMC is the sum of basic pay, the quarters allowance (either cash or in kind), a subsistence allowance (either cash or in kind), and the Federal tax advantages accruing to allowances, since they are not subject to Federal income tax. RMC is BMC plus the average variable housing allowance (which varies by location) and the additional tax advantage it brings. Basic pay represents approximately 76% of BMC or 72% of RMC for all retirement eligibles. For the 20-year retiree, basic pay is approximately 74% of BMC or 70% of RMC. Consequently, a 20-year retiree may be entitled to 50% of basic pay, but only 37% of BMC or 35% of RMC. For a 30-year retiree, the corresponding entitlements are 75% of basic pay but only 60% of BMC or 57% of RMC. These relationships should be considered when military retired pay is compared to compensation under other retirement systems.

Overview

Performance Measures

While there are many ways to measure the funding progress of a pension plan, the ratio of assets in the fund to the present value of future benefits for annuitants on the roll is commonly used. Here is what this ratio has been for the last eight years:

- a. September 30, 1995 = .30375
- b. September 30, 1994 = .30306
- c. September 30, 1993 = .28314
- d. September 30, 1992 = .27018
- e. September 30, 1991 = .25127
- f. September 30, 1990 = .21878
- g. September 30, 1989 = .19549
- h. September 30, 1988 = .16211

Overview _____

Principal Statements

***DOD
MILITARY RETIREMENT
TRUST FUND***

PRINCIPAL STATEMENTS

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Principal Statements

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

| | | Principal Statements | |
|--|----------------------|-----------------------------|-------------|
| Department of Defense DoD Military Retirement Fund Statement of Financial Position as of September 30, 1995 (Thousands) | | 1995 | 1994 |
| ASSETS | | | |
| 1. Entity Assets: | | | |
| a. Transactions with Federal (Intragov (Note 2)) | | | |
| (1). Fund Balances with Treasury (Note 2) | (\$22,202) | \$17,440 | |
| (a) Funds Collected | 82,135,287 | 69,395,215 | |
| (b) Funds Disbursed | (82,174,929) | (69,408,611) | |
| (c) Funds with Treasury | 17,440 | 30,836 | |
| (2). Investments, Net (Note 4) | 126,728,254 | 119,954,091 | |
| (3). Accounts Receivable, Net (Note 5) | | | |
| (4). Interest Receivable | 4,294,988 | 4,226,344 | |
| (5). Advances and Prepayments | | | |
| (6). Other Federal (Intragovernmental) (Note 6) | | | |
| b. Transactions with Non-Federal (Governmental) Entities: | | | |
| (1). Investments (Note 4) | | | |
| (2). Accounts Receivable, Net (Note 5) | 11,203 | 32,540 | |
| (3). Credit Program Receivables/ Related Foreclosed Property, Net (Note 7) | | | |
| (4). Interest Receivable, Net | | | |
| (5). Advances and Prepayments | | | |
| (6). Other Non-Federal (Governmental) (Note 6) | | | |
| c. Cash and Other Monetary Assets (Note 3) | | | |
| d. Inventory, Net (Note 8) | | | |
| e. Work in Process (Note 9) | | | |
| f. Operating Materials/Supplies, Net (Note 10) | | | |
| g. Stockpile Materials, Net (Note 11) | | | |
| h. Seized Property (Note 12) | | | |
| i. Forfeited Property, Net (Note 13) | | | |
| j. Goods Held Under Price Support and Stabilization Programs, Net (Note 14) | | | |
| k. Property, Plant and Equipment, Net (Note 15) | | | |
| l. Other Entity Asset | | | |
| m. Total Entity Assets | <u>\$131,012,243</u> | <u>\$124,230,415</u> | |
| 2. Non-Entity Assets: | | | |
| a. Transactions With Federal (Intragovernmental) Entities: | | | |
| (1). Fund Balance with Treasury (Note 2) | | | |
| (2). Accounts Receivable, Net (Note 5) | | | |
| (3). Interest Receivable, Net | | | |
| (4). Other (Note 6) | | | |

The accompanying notes are an integral part of these statements.

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Principal Statements

Department of Defense
DoD Military Retirement Fund
Statement of Financial Position
as of September 30, 1995
(Thousands)

| Assets Continued | 1995 | 1994 |
|--|----------------------|----------------------|
| 2. Non-Entity Assets Continued: | | |
| b. Transactions With Non-Federal (Governmental) Entities: | | |
| (1). Accounts Receivable, Net | | |
| (2). Interest Receivable, Net (Note 5) | | |
| (3). Other | | |
| c. Cash and Other Monetary Assets (Note 3) | | |
| d. Other Non-Entity Assets | | |
| e. Total Non-Entity Assets | <u>\$0</u> | <u>\$0</u> |
| 3. Total Assets | <u>\$131,012,243</u> | <u>\$124,230,415</u> |
| LIABILITIES | | |
| 4. Liabilities Covered by Budgetary Resources: | | |
| a. Transactions with Federal (Intragovernmental) Entities: | | |
| (1). Accounts Payable | | |
| (2). Interest Payable | | |
| (3). Debt (Note 16) | | |
| (4). Other Federal (Intragovernmental) Liabilities (Note 17) | | |
| b. Transactions with Non-Federal (Governmental) Entities: | | |
| (1). Accounts Payable | \$2,386,616 | \$2,299,603 |
| (2). Accrued Payroll and Benefits | | |
| (a). Salaries and Wages | | |
| (b). Annual Accrued Leave | | |
| (c). Severance Pay and Separation Allowance | | |
| (3). Interest Payable | | |
| (4). Liabilities for Loan Guarantees (Note 7) | | |
| (5). Lease Liabilities (Note 18) | | |
| (6). Pensions and Other Actuarial Liabilities (Note 19) | 128,625,627 | 121,930,812 |
| (7). Other Non-Federal (Governmental) Liabilities (Note 17) | | |
| c. Total Liabilities Covered by Budgetary Resources: | <u>\$131,012,243</u> | <u>\$124,230,415</u> |

The accompanying notes are an integral part of these statements.

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

| Principal Statements | | |
|--|------------------------|------------------------|
| Department of Defense DoD Military Retirement Fund Statement of Financial Position as of September 30, 1995 (Thousands) | | |
| Liabilities Continued | 1995 | 1994 |
| 5. Liabilities not Covered by Budgetary Resources: | | |
| a. Transactions with Federal (Intragovernmental) Entities: | | |
| (1). Accounts Payable | | |
| (2). Debt (Note 16) | | |
| (3). Other Federal (Intragovernmental) | | |
| Liabilities (Note 17) | | |
| b. Transactions with Non-Federal (Governmental) Entities: | | |
| (1). Accounts Payable | | |
| (2). Debt (Note 16) | | |
| (3). Lease Liabilities (Note 18) | | |
| (4). Pensions and Other Actuarial | | |
| Liabilities (Note 19) | \$407,169,188 | \$407,169,188 |
| (5). Other Non-Federal (Governmental) | | |
| Liabilities (Note 17) | 103 | 212 |
| c. Total Liabilities not covered by | | |
| Budgetary Resources | <u>\$407,169,291</u> | <u>\$407,169,400</u> |
| 6. Total Liabilities | <u>\$538,181,534</u> | <u>\$531,399,815</u> |
| NET POSITION (Note 20) | | |
| 7. Balances: | | |
| a. Unexpended Appropriations | | |
| b. Invested Capital | | |
| c. Cumulative Results of Operations | | |
| d. Other | | |
| e. Future Funding Requirements | (407,169,291) | (407,169,400) |
| f. Total Net Position | <u>(\$407,169,291)</u> | <u>(\$407,169,400)</u> |
| 8. Total Liabilities and Net Position | <u>\$131,012,243</u> | <u>\$124,230,415</u> |
| <u>The accompanying notes are an integral part of these statements.</u> | | |

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Principal Statements

Department of Defense
DoD Military Retirement Fund
Statement of Operations (and Changes in Net Position)
For Period Ended September 30, 1994
(Thousands)

| | 1995 | 1994 |
|--|---------------------|---------------------|
| REVENUES AND FINANCING SOURCES | | |
| 1. Appropriated Capital Used | | |
| 2. Revenues from Sales of Goods and Services | | |
| a. To the Public | | |
| b. Intragovernmental | | |
| 3. Interest and Penalties, Non-Federal | | |
| 4. Interest, Federal | \$10,891,234 | \$10,343,786 |
| 5. Taxes (Note 21) | | |
| 6. Other Revenues and Financing Sources (Note 22) | 23,708,444 | 24,716,373 |
| 7. Less: Taxes and Receipts Transferred to the Treasury or Other Agencies | | |
| 8. Total Revenues and Financing Sources | <u>\$34,599,678</u> | <u>\$35,060,159</u> |
| EXPENSES | | |
| 9. Program or Operating Expenses (Note 23) | \$27,904,862 | \$26,804,361 |
| 10. Cost of Goods Sold (Note 24) | | |
| a. To the Public | | |
| b. Intragovernmental | | |
| 11. Depreciation and Amortization | | |
| 12. Bad Debts and Write-offs | | |
| 13. Interest | | |
| a. Federal Financing Bank/Treasury Borrowing | | |
| b. Federal Securities | | |
| c. Other | | |
| 14. Other Expenses (Note 25) | | |
| 15. Total Expenses | <u>\$27,904,862</u> | <u>\$26,804,361</u> |
| 16. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses Before Extraordinary Items | \$6,694,816 | \$8,255,798 |
| 17. Plus (Minus) Extraordinary Items (Note 26) | 109 | 1,600,002 |
| 18. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses | <u>\$6,694,925</u> | <u>\$9,855,800</u> |

The accompanying notes are an integral part of these statements.

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

| | | Principal Statements | |
|---|--|------------------------|------------------------|
| Department of Defense DoD Military Retirement Fund Statement of Operations (and Changes in Net Position) For Period Ended September 30, 1994 (Thousands) | | | |
| EXPENSES Continued | | 1995 | 1994 |
| 19. Net Position, Beginning Balance, as Previously Stated | | (\$407,169,400) | (\$417,025,200) |
| 20. Adjustments (Note 27) | | | |
| 21. Net Position, Beginning Balance, as Restated | | (\$407,169,400) | (\$417,025,200) |
| 22. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses | | \$6,694,925 | \$9,855,800 |
| 23. Plus (Minus) Non Operating Changes (Note 28) | | (\$6,694,816) | |
| 24. Net Position, Ending Balance | | <u>(\$407,169,291)</u> | <u>(\$407,169,400)</u> |

The accompanying notes are an integral part of these statements.

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Principal Statements _____

The accompanying notes are an integral part of these statements.

18

Footnotes

***DOD
MILITARY RETIREMENT
TRUST FUND***

***FOOTNOTES
TO THE
PRINCIPAL STATEMENTS***

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Footnotes _____

Footnotes

**NOTES TO THE DOD MILITARY RETIREMENT FUND
PRINCIPAL STATEMENTS**

Note 1. Significant Accounting Policies:

A. The DoD Military Retirement Fund was authorized in PL98-94 for the accumulation of funds in order to finance on an actuarially sound basis liabilities of the Department of Defense under military retirement and survivor benefit programs. The accounting is accomplished by the Defense Finance and Accounting Service General Accounting Deputate (DFAS-HQ/GC). These financial statements are presented on the accrual basis of accounting in accordance with the requirements of Office of Management and Budget Bulletin 94-01, "Form and Content of Agency Financial Statements."

The program is funded by:

- (1) Annual unfunded liability payment from Treasury
- (2) Monthly Service contributions as a percentage of base pay
- (3) Interest on investments.

B. Change in Accounting Method: For FY 1995 and future years the Military Retirement Trust Fund financial statements will present the unfunded actuarial liability which was determined at the beginning of the fiscal year. This change is in accordance with FAS 35 which permits pension plans to present actuarial data calculated at the beginning of the plan year. This change is needed because of the lengthy time required to develop an accurate end of year actuarial estimate and the accelerated deadlines for financial statements.

Note 2. Fund Balance with Treasury:

(Thousands)

Trust Funds (\$ 22,202)

Securities are redeemed to cover expenses on an estimated basis.

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Footnotes

Note 4. Investments:

| (Thousands) | (1) | (2) | (3) | (4) | (5) |
|---------------------------------|---------------|---------------------|----------------------------|-------------------------------------|------------------------|
| | <u>Cost</u> | <u>Market Value</u> | <u>Amortization Method</u> | <u>Amortized Premium (Discount)</u> | <u>Investments Net</u> |
| A. Intragovernmental Securities | | | | | |
| Non-Marketable | | | Effective | | |
| Market Based | \$131,476,173 | 146,761,497 | Interest | 4,747,919 | 126,728,254 |

The method used to determine amount amortized, book value of investments currently held and related yield on investments conforms to the prevailing practice in the financial community. The calculated yields match up with yields in published security tables of U.S. Treasury securities.

Note 5. Accounts Receivable, Net:

| | |
|-------------------------------------|----------------------|
| (Thousands) | |
| A. Entity Receivables: Governmental | Gross/Net amount Due |
| | \$11,203 |

Note 17. Other Liabilities:

| | |
|---|-------|
| (Thousands) | |
| A. Governmental, Not Covered by Budgetary Resources | |
| Death Payment Contingency | \$103 |

Note 19. Pensions and Other Actuarial Liabilities:

| (Thousands) | (1) | (2) | (3) | (4) | (5) - |
|------------------------|---|----------------------------------|---|------------|-------------------------------------|
| | <u>Actuarial Present Value of Projected Plan Benefits</u> | <u>Assumed Interest Rate (%)</u> | <u>Assets Available to Pay Benefits</u> | | <u>Unfunded Actuarial Liability</u> |
| Major Program Activity | | | | | |
| Pension Plan | 529,100,000 | 6.75% | 121,930,812 | Net Assets | 407,169,188 |

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Footnotes

OTHER INFORMATION: The Military Retirement System is a single-employer plan. It is a defined benefit plan. Administrative costs are not borne by the plan. The Fund uses an aggregate entry-age normal cost funding. The actuarial cost method used is the aggregate entry-age-normal. Projected revenues, as authorized by PL98-94, are to be paid into the Fund at the beginning of each fiscal year by the Secretary of the Treasury as certified by the Secretary of Defense. This permanent indefinite appropriation, determined by the Board of Actuaries, represents the unfunded liability for service performed prior to October 1, 1984.

Change in Accounting Method. For FY 1995 and future years, the Military Retirement Trust Fund financial statements will present the unfunded actuarial liability which was determined at the beginning of the fiscal year. This change is in accordance with FAS 35 which permits pension plans to present actuarial data calculated at the beginning of the plan year. This change is needed because of the lengthy time required to develop an accurate end of year actuarial estimate and the accelerated deadlines for financial statements.

The FY 1995 and 1994 comparative financial statements show the same amount for the unfunded liability due to the change in accounting methods (the FY 1994 unfunded liability is as of the end of year). Future comparative financial statements will show the unfunded liability amount determined at the beginning of the year on a consistent basis.

The amount shown as "Assets Available to Pay Benefits" represents assets available as of October 1 (beginning) of the fiscal year reported, whereas, the amount shown on line 4, b, (6) of the "Statement of Financial Position" represents the amount available as of September 30 (end) of the fiscal year reported.

Note 20. Net Position:

(Thousands)

Future Funding Requirements

1995

| | |
|-------------------------------|---------------|
| A. Actuarial Liabilities | \$407,169,188 |
| B. Non-Actuarial Liabilities | |
| (1) Death Payment Contingency | <u>103</u> |
| Total | \$407,169,291 |

C. Change in Accounting Method: For FY 1995 and future years, the Military Retirement Trust Fund financial statements will present the unfunded actuarial liability which was determined at the beginning of the fiscal year. This change is in accordance with FAS 35 which permits pension plans to present actuarial data calculated at the beginning of the plan year. This change is needed because of the lengthy time required to develop an accurate end of year actuarial estimate and the accelerated deadlines for financial statements.

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Footnotes

Note 22. Other Revenues and Financing Sources:

| (Thousands) | <u>1995</u> | <u>1994</u> |
|--|-------------------|-------------------|
| (1) Normal Cost Contributions from Services | \$12,238,444 | \$12,808,373 |
| (2) Unfunded Liability Payment from Treasury | <u>11,470,000</u> | <u>11,908,000</u> |
| Total | \$23,708,444 | \$24,716,373 |

Note 23. Program or Operating Expenses:

| (Thousands) | <u>1995</u> | <u>1994</u> |
|--|-------------|-------------|
| A. Operating Expenses by Object Classification | | |
| Insurance Claims and Indemnities | 27,904,862 | 26,804,361 |

Note 26. Extraordinary Items:

| (Thousands) | <u>1995</u> |
|--|-------------|
| (1) Changes in Actuarial Liability - (Increase) - Decrease | 0 |
| (2) Death Payment Contingency - (Increase) - Decrease | 109 |

Note 28. Non-Operating Changes:

| | <u>1995</u> | <u>1994</u> |
|--------------------------------------|----------------------|-------------|
| A. Increases: | | |
| (1) Transfers-In | 0 | 0 |
| (2) Donations Received | 0 | 0 |
| (3) Other Increases | <u>0</u> | <u>0</u> |
| (4) Total Increases | 0 | 0 |
| B. Decreases: | | |
| (1) Transfers-In | 0 | 0 |
| (2) Donations Received | 0 | 0 |
| (3) Other Decreases | <u>\$6,694,918</u> | <u>0</u> |
| (4) Total Decreases | <u>\$6,694,918</u> | 0 |
| C. Net Non-Operating Changes: | <u>(\$6,694,918)</u> | 0 |

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Footnotes

D. Other Information: For FY 1995 and future years the Military Retirement Trust Fund financial statements will present non-operating increases or decreases to Net Position which includes the difference between the unfunded actuarial liability determined as of the beginning (October 1) of the respective comparative fiscal years. The FY 1995 "Statement of Operations and Changes in Net Position" shows only the unfunded liability for FY 1995 (as of October 1, 1994) due to the change in accounting methods. Future comparative financial statements will show the increases/decreases on a consistent basis.

Footnotes 3,6,7,8,9,10,11,12,13,14,15,16,18,21,24,25,27,29,30, and 31 are not applicable to the DoD Military Retirement Fund.

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Footnotes _____

Audit Opinion

***DOD
MILITARY RETIREMENT
TRUST FUND***

AUDIT OPINION

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Audit Opinion _____

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Audit Opinion



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884



April 2, 1996

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
AND CHIEF FINANCIAL OFFICER
UNDER SECRETARY OF DEFENSE (PERSONNEL AND
READINESS)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Audit Opinion on the DoD Military Retirement Trust Fund Financial Statements
for FY 1995 (Project No. 5FH-2025)

The Chief Financial Officers (CFO) Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by statutory Inspectors General. The CFO Act prescribes the responsibility of management and the auditors with respect to the financial statements, internal controls, and compliance with laws and regulations. Fund managers are responsible for establishing and maintaining an internal control structure and for complying with laws and regulations applicable to the Military Retirement Trust Fund (the Fund). Our responsibility is to express an opinion on the financial statements based on our audit, and to determine whether internal controls are adequate and whether the Fund complied with applicable laws and regulations.

Unqualified Audit Opinion

In our opinion, the Principal Statements, including the Notes to the Principal Statements, present fairly, in all material respects, the assets, liabilities, and net financial position of the DoD Military Retirement Trust Fund as of September 30, 1995, and the results of operations and changes in net position for the year ended September 30, 1995, in conformity with the accounting principles described below.

Change in Accounting Method. In FY 1995, the Fund changed its method of reporting the unfunded liability. This liability will now be reported as of the beginning of the fiscal year. This change is in accordance with Statement of Financial Accounting Standards No. 35 and is described in more detail in the footnotes of the financial statements.

Accounting Principles. Accounting principles and standards for the Federal Government remain under development. The Federal Accounting Standards Advisory Board was established to recommend Federal accounting standards to the Director, Office of Management and Budget; the Secretary of the Treasury; and the Comptroller General, who establish accounting standards for the Federal Government. Until all aspects of financial statement reporting are governed by accounting standards that will constitute "generally accepted accounting principles for the Federal Government," agencies are required to follow the hierarchy of accounting principles described in OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993.

Appendix B. DoD Military Retirement Trust Fund Financial Statements for FY 1995

Audit Opinion

Scope. We have audited the Principal Statements and Notes to the Principal Statements of the Military Retirement Trust Fund as of September 30, 1995. The Principal Statements include the Statement of Financial Position and the Statement of Operations (and Changes in Net Position).

An audit includes examining, on a test basis, evidence supporting amounts and disclosures in those statements. An audit also includes assessing the accounting principles used, the significant accounting estimates made by management, the internal control structure established for the Fund, and the Fund's compliance with laws and regulations. We believe that our audit provided a reasonable basis for our opinion.

Our review would not necessarily disclose all internal control and compliance conditions that might be considered material weaknesses. Reportable internal control and compliance conditions are summarized in this report and will be further addressed when we issue our reports on internal controls and compliance.

Internal Controls

We reviewed the internal control structure of the Fund and obtained an understanding of the internal control policies and procedures. In addition, we reviewed the implementation of the Management Control Program by the Fund managers. We performed applicable tests of the internal control structure to determine whether the controls were effective and working as designed.

The internal control structure was effective in accounting for and managing resources, ensuring compliance with laws and regulations, and ensuring that the financial statements are free of material misstatements. However, we found internal control weaknesses over debt collection techniques at the Defense Finance and Accounting Service (DFAS) Cleveland and Denver Centers. Those weaknesses are not material to the financial statements, but are considered noncompliant with Public Law 97-365, the Debt Collection Act of 1982.

In its Annual Statement of Assurance, the DFAS Cleveland Center reported a material weakness about the lack of verification of Service personnel data to retiree and annuitant files. We agree with DFAS Cleveland that this is a material weakness; however, our tests did not identify any adverse effects because of this weakness.

Compliance with Laws and Regulations

We reviewed compliance with selected provisions of laws and regulations as they pertain to the accuracy of the financial statements. Our tests of compliance did not disclose any material noncompliance affecting the financial statements. Except for the noncompliance with the Debt Collection Act of 1982 described in the Internal Control section, management complied with the provisions we reviewed.



Robert J. Lieberman
Assistant Inspector General
for Auditing

Appendix C. Prior Audits and Other Reviews

Prior Audits. Since our audit of the DoD Military Retirement Trust Fund Financial Statements for FY 1992, there have been no other audits of the DoD Military Retirement Trust Fund.

We issued an unqualified opinion on the DoD Military Retirement Trust Fund Financial Statements for FY 1992. Our review of internal controls found duplicate payments to three retirees and internal control weaknesses over debt collection techniques. Additionally, the Assistant Secretary of Defense (Force Management and Personnel) had been recommended to the Deputy Secretary of Defense for designation as the Fund manager. Our FY 1995 audit did not identify any additional duplicate payments to retirees and annuitants. In April 1994, the Deputy Secretary of Defense designated the Under Secretary of Defense (Personnel and Readiness) as the Fund manager. In our FY 1995 audit, however, we did find that interest was still not charged on all retiree and annuitant debt which is discussed in Part I.A.

Other Reviews. The DFAS included the Fund as 1 of 5 areas reviewed in an anti-fraud detection project called Operation Mongoose. The DFAS established Operation Mongoose with the DoD Inspector General and the Defense Manpower Data Center in August 1994. The purpose of the project was to identify irregular data profiles that require additional investigation by tracking, matching, comparing, and monitoring high risk data. As part of that project, Operation Mongoose staff members, and members of the DoD Inspector General Office and the U.S. Secret Service traveled to the Republic of the Philippines and Guam in FY 1995 to verify the existence of retired military and civilian DoD employees and their surviving dependents who were receiving payments. As a result of that trip, the Operation Mongoose project identified \$3.9 million of improper retiree and annuitant payments and \$2.2 million of potentially improper retiree and annuitant payments. Additionally, the Operation Mongoose project identified six duplicate retiree accounts and six cases of fraudulent receipt of an annuity based on an analysis of data maintained at the DFAS Cleveland Center and the Social Security Administration.

Appendix D. Laws and Regulations Reviewed

Subtitle III, Financial Management, Title 31, United States Code, including the requirements for accounting and accounting systems and information in 31 U.S.C. 3511, 3512, 3513, and 3514; and financial statement requirements in 31 U.S.C. 3515

Subtitle A, General Military Law, Title 10, United States Code, Armed Forces (As Amended Through December 31, 1994), Chapter 74 - Department Of Defense Military Retirement Fund March 1995

Public Law 96-513¹, "Personnel Management Act of 1981," December 12, 1980

Public Law 97-365, "Debt Collection Act of 1982," October 25, 1982

Public Law 98-94², "Department of Defense Authorization Act of 1984," September 24, 1983

Public Law 98-369³, "Deficit Reduction Act of 1984," July 18, 1984

Public Law 99-177, "Public Debt Limit-Balanced Budget & Emergency Deficit Control Act of 1985,"

Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990

Public Law 102-484, "National Defense Authorization Act for Fiscal Year 1993," October 23, 1992

Public Law 103-62, "Government Performance and Results Act of 1993," August 3, 1993

Public Law 103-337, "Department of Defense Authorization Act of 1995," October 5, 1994

Public Law 103-356, "Government Management Reform Act of 1994," October 13, 1994

OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993

OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993

OMB Circular No. A-123, "Internal Control Systems," June 21, 1995

¹Changed computation method to high 36 months' pay.

²Established the Military Retirement Trust Fund.

³Made entitlements payable at the beginning of the month.

Appendix D. Laws and Regulations Reviewed

OMB Circular No. A-129, "Managing Federal Credit Programs," November 25, 1988

OMB Statement of Federal Financial Accounting Standards and Concepts

Treasury Financial Manual, June 12, 1990

DoD Directive 5010.38, "Internal Management Control Program," April 14, 1987

DoD Directive 7200.1, "Administrative Control of Appropriations," as revised May 4, 1995

DoD Directive 7045.13, "DoD Credit Management and Debt Collection Program," October 31, 1986

DoD Instruction 7220.9, "DoD Accounting Policy," October 1981

"DoD Guidance on Form and Content of Financial Statements for FY 1994/1995 Financial Activity," October 20, 1994, as supplemented by guidance dated November 27, 1995

DoD Financial Management Regulation 7000.14R, Volume 1, "General Financial Management Information, Systems, and Requirements," May 1993

DoD Financial Management Regulation 7000.14R, Volume 5, "Disbursing Policy and Procedures," December 1993

DoD Financial Management Regulation 7000.14R, Volume 7B, "Military Pay Policy and Procedures for Retired Pay," June 1995

DoD Financial Management Regulation 7000.14R, Volume 14, "Administrative Control of Funds and Antideficiency Act Violations," August 1995

Appendix E. Organizations Visited or Contacted

Office of the Secretary of Defense

Office of the Under Secretary of Defense (Comptroller), Arlington, VA
Office of the Deputy Comptroller (Program and Budget), Director of Revolving Funds, Washington, DC
Office of the Deputy Comptroller (Financial Systems), Director of Accounting Policy, Washington, DC
Office of the Under Secretary of Defense (Personnel and Readiness), Arlington, VA
Defense Manpower Data Center, Monterey, CA
Office of the Actuary, Arlington, VA

Department of the Army

Army Reserve Support Center, Arlington, VA
Army National Guard, National Guard Bureau, Arlington Hall Station, Arlington, VA
Army Reserve Personnel Center, St. Louis, MO
Army Reserve Support Center, Arlington, VA

Department of the Navy

Bureau of Naval Personnel, Arlington, VA
Retirements Fleet Reserve and Disability Retirement Division, BUPERS, Navy Annex, Arlington, VA
Navy Reserve Personnel Center, New Orleans, LA
Headquarters, Marine Corps, Arlington, VA

Department of the Air Force

Air Force Manpower Center, Randolph AFB, TX
Air Reserve Personnel Center, Denver, CO

Other Defense Organizations

Headquarters, Defense Finance and Accounting Service, Arlington, VA
Columbus Center, OH
Denver Center, CO
Indianapolis Center, IN
Kansas City Center, KS

Non-Defense Federal Organization

National Personnel Records Center, St. Louis, MO

Appendix F. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition and Technology
Director, Defense Logistics Studies Information Exchange
Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Under Secretary of Defense (Personnel and Readiness)
Deputy Under Secretary of Defense (Requirements and Resources)
Director, Defense Manpower Data Center
Chief Actuary, DoD Office of the Actuary
Assistant to the Secretary of Defense (Public Affairs)

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Finance and Accounting Service
 Director, Defense Finance and Accounting Service Cleveland Center
 Director, Defense Finance and Accounting Service Denver Center
 Director, Defense Finance and Accounting Service Indianapolis Center
 Director, Defense Finance and Accounting Service Kansas City Center
Director, Defense Commissary Agency
Director, Defense Contract Audit Agency
Director, Defense Information Systems Agency
Director, Defense Logistics Agency
Director, National Security Agency
 Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations

Office of Management and Budget
Technical Information Center, National Security and International Affairs Division,
 General Accounting Office

Chairman and ranking minority member of each of the following congressional
committees and subcommittees:

Senate Committee on Appropriations
 Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
 House Subcommittee on National Security, Committee on Appropriations
House Committee on National Security
House Committee on Government Reform and Oversight
 House Subcommittee on National Security, International Affairs and Criminal
 Justice, Committee on Government Reform and Oversight

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This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, Department of Defense.

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E. Distribution Statement A: Approved for Public Release

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